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SUBJECT: Emerging Market Jitters Weaken Rand, Inflation Diminishes
Growth Prospects

REF: Pretoria 2395

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¶1. (SBU) Summary. Emerging market jitters in May and June led to a roughly 20 percent depreciation in the rand, contributing to a growing current account deficit and higher inflation. As a result, growth in 2006 will likely be below the government's forecast of 4.9 percent. Other than contributing to slower growth, the emerging market weakness has had relatively little negative effect. The current account deficit, financed primarily by short term capital flows, is the key vulnerability. End Summary.

¶2. (U) Declining commodity prices, particularly gold, and cooling investor interest in emerging markets led to the first notable deprecation in the rand in over three years. The rand began May at approximately R6/$, hit R7.5/$ in late June and closed the month at roughly R7.2/$. Citing an unstable international environment, local analysts are reserving judgment on the future direction of the rand. Few expect export growth to pick up in the short term.

¶3. (U) In early June the South African Reserve Bank's Monetary Policy Committee (MPC) raised its repurchase (repo) rate 50 basis pionts, noting that it expected inflation to breach the upper end of its target range of 3-6 percent (reftel). Subsequent data releases support the prediction of higher inflation, largely due to high oil and food prices. The CPIX (CPI minus mortgage costs) rose 4.1 percent in May, up from 3.7 percent in April. The PPI also rose 5.9 percent in May from 5.5 percent in April.

¶4. (U) In raising the repo rate, the MPC also cited a sharp increase in the current account deficit, which registered 6.4 percent of GDP in the first quarter, against 4.5 percent in the fourth quarter of 2005 and the widest in two years. StatsSA subsequently reported that the trade deficit hit R7 billion in May. Higher oil prices and strong consumer demand pushed imports up 30 percent, while exports grew 15.6 percent. Analysts had expected a trade deficit of about R2 billion.

¶5. (SBU) The Reserve Bank's Monetary Policy Committee meets again in August. Given continued inflationary pressure and current account weakness, analysts expect another rate hike, probably 50 basis points. The higher interest rates will likely restrain consumer spending, a key factor in South Africa's recent strong growth.

¶6. (SBU) Growth is already showing signs of a slow down. The Reuters Econometer Confidence Index fell to a 14-month low of 258 in June. The SACOB Business Confidence Index fell below 100 (neutral) in June, and the FNB/BER consumer confidence index also fell slightly, from 21 to 20. The rate of growth in housing price

increases slowed to four and a half year low of 13.6 percent (y/y) in June, while the growth rate for new vehicle car sales continued to slow, dropping to 13.8 percent (y/y) in June. While both rates are still healthy, there are sharply below levels of a year ago. Analysts expect growth this year to be below the government's official projection of 4.9 percent: they are currently estimating in the neighborhood of 4.2 percent, healthy but short of the government's objective of 6 percent.

¶7. (SBU) Ratings agencies Standard and Poor's and Fitch have recently completed their annual reviews of the South African economy. Both are uncertain about short term direction of the economy and are cautious about another ratings upgrade this year. Fitch noted that "we need to see how this volatility is managed ..."

¶8. (SBU) Comment. South Africa's economic fundamentals remain sound. Emerging market weakness has contributed to slower growth but otherwise has had relatively little negative effect. Also, there are so far no signs of increased political risk premiums due to the emerging debate on succession to President Mbeki. Still as a small, open economy South Africa remains susceptible to the vagrancies of international views on emerging markets. The current account deficit is the key vulnerability. Financed primarily by short term capital flows, a large movement out of emerging markets could put renewed pressure on the rand, undermine confidence and further lower growth. TEITELBAUM